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CITATIONS

Cases:

IN THE

Supreme Court of the United States

October Term, 1948

No.

OTTO A. KOHL,
Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

To the Honorable, the Chief Justice and the Associate Justices of the Supreme Court of the United States

The petitioner, Otto A. Kohl, respectfully prays that a writ of certiorari issue to review the judgment of the Court of Appeals for the Eighth Circuit entered November 12, 1948, affirming the decision of The Tax Court of the United States.

OPINIONS BELOW

The memorandum opinion of The Tax Court (R. 22-31) is not officially reported. The opinion of the Court of Appeals (R. 150-159) is reported in 170 F. 2d 531.

JURISDICTION

Judgment of the Court of Appeals was entered on November 12, 1948 (R. 159-160). Petitioner filed a timely petition for rehearing which the Court of Appeals denied on December 6, 1948 (R. 169). On application of the petitioner, the Court of Appeals ordered a stay of its mandate until January 15, 1949 (R. 170). The jurisdiction of this court is invoked under 28 U.S.C. 1254.

QUESTIONS PRESENTED

1. Whether the court below departed from the decisions of this court in *Commissioner v. Tower*, 327 U.S. 280 and *Lusthaus v. Commissioner*, 327 U.S. 293, in affirming The Tax Court's decision that business income of the partnership, of which petitioner was a member, was includable in taxpayer's gross income as defined in Section 22(a) of the Internal Revenue Code.

2. Whether the court below, in affirming the decision of The Tax Court, rendered a decision in conflict with the decisions of Courts of Appeal of other Circuits, and in conflict with its own decisions.

3. Whether the court below, in affirming The Tax Court, laid down tests in determining the validity of so-called family partnerships for tax purposes not contemplated by Sections 181 and 182 of the Internal Revenue Code and which tests never heretofore have had judicial sanction.

4. Whether the court below, in affirming the decision of The Tax Court, denied to the petitioner constitutional rights guar-

anteed by the Fifth and Sixteenth Amendments to the Constitution of the United States.

STATUTES AND CONSTITUTIONAL PROVISIONS INVOLVED

The pertinent portions of the Internal Revenue Code (Sections 22(a), 181, 182 and 3797) and the Fifth and Sixteenth Amendments to the Constitution of the United States are set forth in the appendix, *infra* pages 17-18.

STATEMENT

The material facts are not at variance with the findings of The Tax Court (R. 22-28) and may be summarized as follows:

Prior to April 21, 1941, the petitioner, residing in Cedar Rapids, Iowa, was engaged in business as an individual proprietor under the name and style of "Bupane Gas Company." The company was engaged in the bottling, sale and distribution of liquefied or bottled gas for domestic use, and the sale of appliances to be used therewith. The petitioner had commenced the business in 1933 on a very small scale. The method of operation was to obtain the gas in carload lots, to place the gas under pressure in steel cylinders owned by the petitioner and to distribute the bottled gas to ultimate consumers, through retail outlets operated by the petitioner and through other distributors (R. 49, 55).

In 1935, the petitioner associated in the business Clarke Van Meter, who is not a member of the petitioner's family. Clarke Van Meter was a graduate engineer, holding a degree from

the Iowa State College at Ames, Iowa (R. 84). In 1936, the petitioner associated in the business Marvin M. Cobb, who is not a member of the petitioner's family. Marvin M. Cobb was a graduate of the University of Iowa, Iowa City, Iowa, and majored in accounting (R. 50, 66 and 67). As Clarke Van Meter and Marvin M. Cobb gained experience in the business, their duties and responsibilities were increased. It was the desire of the petitioner to relinquish a large part of the general management of the business and to devote a major portion of his time to new product development and other business interests. The petitioner was interested in developing new products from diatomaceous earth and other materials (R. 50, 51 and 74).

Just prior to April 21, 1941, the petitioner advised Clarke Van Meter and Marvin M. Cobb of his intention to relinquish to them a substantial part of the management of the business of the Bupane Gas Company and that the petitioner in the future would devote a part of his time to new products and product development and to other outside business interests (R. 67, 68, 74). Clarke Van Meter was made general manager of the business and had the general supervision of manufacturing, distribution, advertising, sales, purchases and the employment and discharge of personnel (R. 53, 54, 55, 85, 86, 87). Marvin M. Cobb had general supervision of all the accounting, books and records, insurance, legal matters, auditing, branch establishments and collections (R. 53, 54). The authority to sign checks was vested in Clarke Van Meter and he signed approximately 97% of all the checks issued by the company in 1941 (R. 62, 87). The accounts or items for which checks were to be issued were first passed upon by Marvin M. Cobb and the checks were then prepared for Clarke Van Meter's signature (R. 75).

On or about April 21, 1941, the petitioner, as trustor and Clarke Van Meter and Marvin M. Cobb, as trustees, entered into a trust agreement (R. 123-129, Petitioner's Exhibit 4). Subsequently, when the trustor's son, Otto A. Kohl, Jr., attained the age of 21 years, he became a trustee under the trust agreement (R. 56). The trustees were authorized to make investments and to incur indebtedness in connection therewith (R. 124), and were authorized to pay the income from the trust to the trustor's wife, Dorothy Kohl, and to the trustor's children and the children's spouses, and to the issue of the children. The trust was to continue during the lifetime of the petitioner's wife, Dorothy Kohl, or until the petitioner's youngest child attained the age of 21 years, whichever should last occur, unless the trustees, in their discretion, should sooner close the trust and distribute the assets (R. 125). The trust was expressly declared to be irrevocable and the petitioner retained no interest in the trust property (R. 127).

Thereafter, and on or about April 30, 1941, the petitioner and the trustees under said trust entered into an agreement which provided for the transfer of 49% of the assets of the Bupane Gas Company to the trustees for the agreed price of $44,273.97, and that thereafter the trustees and the petitioner would carry on the business of the Bupane Gas Company on the basis of 49% thereof being owned by the trust and 51% by the petitioner, with the sharing of profits or losses on the same basis (R. 130, Petitioner's Exhibit 5). A note representing the unpaid balance of the purchase price was given by the trustees to the petitioner (R. 136, Petitioner's Exhibit 8). Subsequently, the note was paid by the trustees out of distributions which were received from the operations of the business (R. 81).

Commencing with May 1, 1941, the business of the Bupane Gas Company was conducted as a partnership pursuant to the agreement (R. 130, Petitioner's Exhibit 5). The agreement expressly provided that the petitioner and the trustees would engage in and conduct the business of the Bupane Gas Company (R. 129). Pursuant to the obligations under the agreement, the trustees, Clarke Van Meter and Marvin M. Cobb, performed the services of general manager and auditor and accountant, and generally conducted the operations of the business. Thereafter the petitioner devoted such a large part of his time to product development and matters outside of the general conduct of the business that the record shows without dispute he was only devoting approximately 25% of his time to the principal place of business and the general business activities of the partnership (R. 53, 86).

The Bupane Gas Company filed its partnership income tax return for a fiscal period ending January 31, 1942. The petitioner in his Federal income tax return for the calendar year 1941 reported income, so far as it arose from the Bupane Gas Company operations, only for the period of the single proprietorship, to-wit, from January 1, 1941, to May 1, 1941. The petitioner did not report in his 1941 income tax return the income of the Bupane Gas Company from May 1, 1941, through December 31, 1941, because a valid and subsisting partnership existed between the petitioner and trust, acting through its trustees.

The respondent disregarded both the trust and the partnership and arbitrarily decided that 8/9ths of the entire income of the partnership for the period from May 1, 1941, to January 31, 1942, *i.e.*, the first fiscal period of the partnership,

should be included in the taxable income of the petitioner for the calendar year 1941 and determined deficiency in the income tax liability of the petitioner for said taxable year in the amount of $19,036.94.

The petitioner appealed to The Tax Court of the United States and The Tax Court affirmed the determination of the respondent by decision entered April 25, 1947, and the Court of Appeals affirmed the decision of The Tax Court November 12, 1948 (R. 150-159).

SPECIFICATION OF ERRORS TO BE URGED

The Court of Appeals erred:

1. In holding contrary to the decisions of this court in *Commissioner v. Tower*, 327 U. S. 280, and *Lusthaus v. Commissioner*, 327 U. S. 293, that the claimed partnership between the petitioner and the Otto A. Kohl trust was not entitled to recognition for Federal income tax purposes, regardless of the undisputed fact that the trust, through its trustees, "substantially contributed to the control and management of the business" and "perform(ed) vital additional services."

2. In deciding this case contrary to the decisions of the Courts of Appeal for other Circuits, and contrary to other contemporaneous decisions of the Eighth Circuit itself.

3. In applying tests for the determination of the validity of a partnership for Federal tax purposes not contemplated by Sections 181 and 182 of the Internal Revenue Code, and tests which never heretofore have had judicial sanction.

4. In disregarding the constitutional rights of the petitioner guaranteed by the Fifth and Sixteenth Amendments to the Constitution of the United States.

5. In affirming the judgment of The Tax Court.

REASONS FOR GRANTING THE WRIT

1. Partnership is an ancient and honorable form of business organization widely used in the transaction of business since the earliest days of our nation, and ante-dating any provision for Federal income taxation. Sections 22(a), 181, and 182 of the Internal Revenue Code were enacted by Congress upon this background. The decisions of *Commissioner v. Tower*, 327 U.S. 280 and *Lusthaus v. Commissioner*, 327 U. S. 293, announced certain principles of law as applicable to the taxation of partners which for many years prior thereto had not been so applied by taxpayers in justifiable reliance upon many rulings of the respondent and decisions of the courts in which the respondent had acquiesced. The subsequent application and administration of these principles has brought about extensive confusion in both lay and legal minds, as well as extensive litigation. Numerous cases have been decided by the various Courts of Appeal applying these cases and the docket of The Tax Court of the United States is literally clogged by hundreds of similar cases awaiting trial and decision. In addition, a large number of cases are backed up for administrative determination within the Bureau of Internal Revenue. This case further indicates the confusion which exists as to the application of the principles which were announced in the *Tower* and *Lusthaus* cases.

The most fundamental and flagrant disregard of the doc-

trine of the *Tower* and *Lusthaus* cases occurred here, when the lower court and The Tax Court, in complete disregard of the record, violated the test laid down by this court that a partnership is valid for tax purposes as to a partner who substantially contributes to the control and management of the business or otherwise performs vital additional services. It is without dispute in the record and The Tax Court found (R. 24) that the trustees substantially contributed to the control and management of the business. In fact, the functions performed by the trustees were substantially all of the management and operating functions of the business (R. 24).

Another test laid down by the *Tower* and *Lusthaus* cases was that the capital must originate with the partner. It is submitted that where the capital interest is purchased, as in this case, even though paid for with the earnings of the business, it has an independent origin within the meaning of the language as used in the *Tower* case, and that the lower court disregarded this test in affirming The Tax Court.

It is believed to be a fair interpretation also of the *Tower* and *Lusthaus* cases that they intended to announce as one test that the partners really and truly intended to join together for the purpose of carrying on business. If there is anything which the partners in this case intended to do, it was really and truly to form a partnership. All parties in interest testified that the trust and partnership agreements were entered into for a business purpose and resulted in a substantial change in the relative rights of the parties and their method of doing business.

The decision of the lower court is tantamount to holding that under no circumstances, and regardless of whether the

tests of the *Tower* and *Lusthaus* cases are met, a trust can never be a partner in a partnership for Federal income tax purposes unless possibly such a partnership was found to be necessary (see *infra*) and the beneficiaries as opposed to the trustees performed sufficient services.

The court below refers to the case of *Economos v. Commissioner*, 167 F. 2d 165 (C.C.A. 4th), but fails to quote the material part of the opinion. In the *Economos* case the trust was denied recognition as a partner because, as the court says:

> "The trustee was not obligated to devote any time to the business and did not render any services * * *"

which is an entirely different situation wholly inapplicable to this case and which is an arrangement that does not meet the tests of the *Tower* and *Lusthaus* cases.

This court in Docket 313 granted certiorari on December 6, 1948, in the case of *Culbertson v. Commissioner*, 168 F. 2d 979 (C.C.A. 5th) apparently on the ground that a question was presented whether the *Culbertson* case represented a departure from the doctrine of the *Tower* and *Lusthaus* cases. It is respectfully submitted that the petitioner, as an individual taxpayer, confronted with the same misapplication of the same decisions, is entitled to a review of his case by this court.

2. This case reflects the confusion in the Courts of Appeal for the various Circuits. The decision is not only contrary to decisions in similar cases in other circuits;[1] it is in fact contrary

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[1] *Graber v. Commissioner*, 48-2 U.S.T.C. Par. 9409 (C.C.A. 10th); *Kent v. Commissioner*, 170 F. 2d 131 (C.A. 6th); *Culbertson v. Commissioner*, 168 F. 2d 979 (C.C.A. 5th); *Arnold v. Schepps*, 166 F. 2d 821 (C.C.A. 5th); *Lawton*

to contemporaneous decisions of the lower court in the same circuit.[2]

The lower court stressed the supposed control of the petitioner over the partnership business.

The rights which the trust and the partnership agreement gave to the petitioner were, so far as the partnership was concerned, only the customary provisions that a majority interest may settle disputes and insofar as the trust was concerned only those which have been repeatedly recognized by judicial precedent as not subjecting the settlor of a trust to taxation on the income of the trust.

Lawton v. Commissioner, 164 F. 2d 380 (C.C.A. 6th), squarely held that a provision for a decision by a majority in value in a partnership to control the management of the partnership did not invalidate the partnership for tax purposes. The lower court in this case, predicating its decision on the supposed control of the petitioner, is in square conflict with the decision in *Lawton v. Commissioner, supra.*

The lower court's decision, to the extent predicated on the dominion and control of the petitioner over the trust, is in square conflict with the decisions of the Second Circuit in *Kohnstamn v. Pedrick*, 153 F. 2d 506 (C.C.A. 2nd), and

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v. Commissioner, 164 F. 2d 380 (C.C.A. 6th); *Weizer v. Commissioner*, 165 F. 2d 772 (C.C.A. 6th); *Woosley v. Commissioner*, 168 F. 2d 330 (C.C.A. 6th); *Canfield v. Commissioner*, 168 F. 2d 907 (C.C.A. 6th); *Simmons v. Commissioner*, 164 F. 2d 220 (C.C.A. 5th); *Wilson v. Commissioner*, 161 F. 2d 661 (C.C.A. 7th); *Durwood v. Commissioner*, 159 F. 2d 400 (C.C.A. 8th); *Thomas v. Feldman*, 158 F. 2d 488 (C.C.A. 5th).

[2] *Walsh v. Commissioner*, 170 F. 2d 535 (C.A. 8th); *Hartz v. Commissioner*, 170 F. 2d 313 (C.A. 8th).

Cushman v. Commissioner, 153 F. 2d. (C.C.A. 2nd). In these cases it was held that settlors who had retained broad powers over investments, and particularly the right of veto, did not have such control as to cause the income to be taxed to the settlors. In similar decisions such as *Lowe v. Commissioner*, 7 T.C. 363 (acquiescence 1946, 2 C.B. 3) and *Wheelock v. Commissioner*, 7 T.C. 98 (acquiescence 1946, 2 C.B. 5) The Tax Court has held that where settlors retained, among other powers, the right to control trust investments, or the veto thereof, such retained powers did not require the inclusion of the trust income in the income of the settlors. These cases were acquiesced in by the respondent.

The lower court, on November 12, 1948, decided the case of *Walsh v. Commissioner*, 170 F. 2d 535 (C.A. 8th), in which a minor daughter of tender years who had received her interest by gift, and who was represented by a guardian, was held to be a recognized partner for income tax purposes in a punch board business in the State of Nebraska. Likewise, the mother of the minor child who had also received an interest in the same business by gift was recognized as a partner. The child's father, who was approximately 22 years of age at the time, was also recognized as a partner. Thus the Eighth Circuit had no hesitancy in holding valid for tax purposes a partnership in a punch board business where the father, his wife and his minor daughter who had received their interests by gift, were the partners. And yet, at substantially the same time, the same court in this case found no virtue in a legitimate bottled gas business where the trust substantially operated and controlled the business and had acquired its interest in the business by a bona fide purchase, and for which it had fully paid.

On October 27, 1948, the lower court entered a decision

and opinion in the case of *Hartz v. Commissioner*, 170 F. 2d 313 (C.A. 8th) in which parents and other relatives who had purported to acquire interests in a chain store business for nominal considerations or gifts, and who, as the record indicates, were merely on the fringe and looking on, were recognized as partners for tax purposes in a chain store business in the State of Minnesota.

It is respectfully submitted where numerous so-called family partnerships are being repeatedly recognized in other Circuits on principles which the lower court disregarded in this case and where the lower court in substantially contemporaneous decisions is applying principles clearly inconsistent with the principles applied by the lower court in this case, this petitioner should be granted a review of his case.

3. The Tax Court in its decision, and the lower court in affirming, applied principles or tests for determining the validity of the partnership for tax purposes which are not embraced within any of the sections of the Internal Revenue Code and which have not heretofore received judicial sanction.

The Tax Court in its opinion (R. 30) concluded as a matter of law that neither the trust nor the partnership was "necessary" for the accomplishment of the objectives which the record shows the petitioner had, to-wit, the transfer of the primary management function to the trustees and the freeing of the petitioner from management duties so that he could follow other pursuits. No case involving a family partnership has yet been decided in which the test of the validity for tax purposes has been made to depend upon the necessity of the partnership. If this doctrine were to be announced and carried out, then no transfer of property under any circumstances could

shift the incidence of taxation on the income to the transferee unless the transfer was *necessary*.

The Tax Court also found (R. 30), and its conclusion was affirmed by the lower court, that the transaction served no purpose except the reallocation of the petitioner's income within his family group. The record indisputably shows a business purpose for the formation of the partnership. Every recognized family partnership results in some reallocation of the family income. Every gift between husband and wife results in some such reallocation. But it is submitted the validity of a partnership is not to be determined because such a reallocation exists where the record clearly shows a true business purpose is present. The Tax Court and the lower court applied tests in this case which have no judicial sanction and no express provision therefor in the Internal Revenue Code.

4. The lower court and The Tax Court denied to the petitioner the protection to which he is entitled under the Fifth and Sixteenth Amendments to the Constitution of the United States. After the establishment of the trust and the commencement of business as a partnership, the trust became entitled and received 49% of all the income from the partnership operations. The petitioner had no further interest therein and had absolutely no right or power under Iowa law or any other law to recapture at any time any of the income. It cannot be said that he had the gratification or satisfaction of earning the income or that it passed through his hands directly or indirectly, since the income was largely earned through the efforts of the trustees of the trust in managing and directing the business, and 49% of the net income accrued directly and irrevocably to the trustees.

The Sixteenth Amendment to the Constitution of the United States authorizes Congress to lay and collect taxes on income from whatever source derived and without apportionment. In *United States v. Safety Car Heating and Lighting Company*, 297 U. S. 88, this court held that income within the meaning of the Sixteenth Amendment is income as the word is known in the common speech of man. Certainly, it was the intent of Congress in proposing the amendment, and of the people in ratifying it, that the income subject to taxation was the income of the particular taxpayer and not the income of another.

This conclusion is abundantly supported by the factual situations which may develop in the case of many taxpayers, and which developed in the case of this taxpayer in subsequent years after 1941. It appears from the record (R. 82) that the net profit of the partnership for the 1944 period was slightly in excess of $60,000.00. Of this amount the petitioner's share was about $30,600, and the balance belonged to the trust. However, the income taxes at the applicable rates for 1944 on $60,000.00 if all is taxed to the petitioner, would be approximately $36,000. In other words, to tax to the petitioner the income of the trust will require the taxpayer to pay more in income taxes than the total amount of the income which he received or which it is ever possible for him to receive. The trustees of the trust have no right, power or authority to aid or assist the petitioner in any way in the payment of his taxes, or to make any of the funds of the trust available to him for the payment of taxes. The situation is very different from the usual husband and wife or father and son situation, where by cooperation within the economic group the funds may be made legally available so as to ameliorate the burden of the taxpayer.

Likewise, to tax to the petitioner what is in law and fact the income of another, and particularly where the amount claimed in taxes exceeds the entire fruits of the endeavor of the taxpayer, is to take his property without due process and in violation of the Fifth Amendment of the Constitution of the United States.

It is respectfully submitted that the taxpayer is entitled to a review and consideration of this unwarranted invasion of his constitutional rights.

CONCLUSION

The petition for writ of certiorari should be granted.

Respectfully submitted,

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APPENDIX

Internal Revenue Code:

Sec. 22. Gross Income.

(a) *General Definition.* — "Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service * * *, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * * (26 U.S.C. 1946 ed., Sec. 22.)

Sec. 181. Partnership Not Taxable.

Individuals carrying on business in partnership shall be liable for income tax only in their individual capacity. (26 U.S.C. 1946 ed., Sec. 181.)

Sec. 182. Tax of Partners.

In computing the net income of each partner, he shall include, whether or not distribution is made to him —

* * * * * * *

(c) His distributive share of the ordinary net income or the ordinary net loss of the partnership, computed as provided in section 183(b). (26 U.S.C. 1946 ed., Sec. 182.)

Sec. 3797. Definitions.

(a) When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof —

* * * * *

(2) *Partnership and Partner.* — The term "partnership" includes a syndicate, group, pool, joint

venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term "partner" includes a member in such a syndicate, group, pool, joint venture, or organization.

* * * * *

(26 U.S.C. 1946 ed., Sec. 3797.)

Amendments to the Constitution of the United States:

Amendment 5. No person shall * * * be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation.

Amendment 16. The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.

INDEX

CITATIONS

In the Supreme Court of the United States

October Term, 1948

No. 509

Otto A. Kohl, petitioner

v.

Commissioner of Internal Revenue

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The memorandum opinion of the Tax Court (R. 23-31) is not reported. The opinion of the Court of Appeals (R. 150-159) is reported at 170 F. 2d 531.

JURISDICTION

The judgment of the Court of Appeals was entered November 12, 1948. (R. 159-160.) Taxpayer's petition for rehearing was denied December 6, 1948. (R. 169.) The petition for a writ of cer-

tiorari was filed January 13, 1949. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254.

QUESTION PRESENTED

Whether the court below erred in affirming the Tax Court's decision that business income attributed by taxpayer to a trust for the benefit of his wife and children under a so-called partnership agreement was includible in taxpayer's gross income as defined in Section 22 (a) of the Internal Revenue Code.

STATUTE AND REGULATIONS INVOLVED

These appear in the Appendix, *infra*, pp. 12-14.

STATEMENT

The facts as found by the Tax Court (R. 23-31) may be summarized as follows:

From 1933 until 1941 (the taxable year) taxpayer conducted, as sole proprietor, a business of bottling and distributing liquefied petroleum gas for domestic use. (R. 23.) He was married and had three minor children, the eldest of whom was seventeen years old in 1941 and was attending college. (R. 25.)

In 1935 taxpayer employed one Van Meter to perform office work, and in 1936 he employed one Cobb as an accountant. Early in 1941 Van Meter was designated general manager of the business, and Cobb was designated comptroller. Taxpayer enlarged the duties and responsibilities of these

employees in order to devote more of his time to the development of new products. By April of 1941 taxpayer had practically relinquished the routine management of the business to these employees, and devoted between 25 and 30% of his time to the promotion of new products. He retained, however, the right to make all major decisions affecting the business, and Van Meter and Cobb consulted him frequently. Van Meter's salary was $2,850 in 1941 while Cobb's salary was $2,400. (R. 23-24, 29.)

On April 21, 1941, taxpayer executed an irrevocable trust agreement naming Van Meter and Cobb as trustees, and his wife and children as beneficiaries. On April 30, 1941, taxpayer executed a partnership agreement with Van Meter and Cobb as trustees, whereby he purported to sell to them as trustees a 49% interest in his business, in consideration of $44,273 (representing 49% of the book value of the business) evidenced by a promissory note payable within ten years at 2% interest. The note was payable only from net profits of the business, and the net profits were to be apportioned 51% to taxpayer and 49% to the trust. Under the trust instrument the trustees were given control over the trust property, but were expressly prohibited from making any sale or investment during taxpayer's lifetime without taxpayer's written approval. (R. 24-26.) Under the partnership

agreement taxpayer (referred to as the "First Party") reserved (R. 26)—

> the right to determine all questions of buying or selling either real or personal property, or renting the same, or any part thereof, and pledging the credit of the Company whenever he deem it necessary, in the exercise of his judgment and discretion necessary and proper to do so, and to determine credits to be extended by the Company in the carrying on and conduct of its business and the pledges of credit to be taken by the Company to secure any credits extended in order to preserve the rights and protect the interests of the Company, and that whenever a question arises about which there is a difference of opinion, as between or among the parties hereto, the ultimate determination of the First Party as to the course to be pursued in any such matter, shall be final and binding upon all of the parties hereto.
>
> * * *
>
> It is further agreed and understood between the parties hereto that First Party has, and is hereby given the right to determine the number of and who shall be the employees of said Bupane Gas Company, and the compensation to be paid to each and all of said employees at any time during the period covered by this contract.

Entries were thereafter made on the books of the business to reflect a 51% and 49% ownership

of its net worth by taxpayer and the trust respectively, and the business was registered as a partnership. (R. 27.)

The note given by the trust to taxpayer as the purchase price of a 49% interest in the business was paid by the business on behalf of the trust in three installments in 1942, 1943 and 1944. A bank account was first opened in the name of the trust in 1944, at which time monthly disbursements were made by the business to the trust account. The first distribution to the trust beneficiaries was made in 1946 in the form of paid-up life insurance for the beneficiaries. Van Meter and Cobb received trustees' fees of $2,000 each from the trust in 1944, 1945 and 1946. (R. 27-28.)

The trust invested no capital originating with it, and had none to invest; the trustees merely purported to purchase a partnership interest from taxpayer, and paid for such interest out of the profits allocated to the trust as a partner. Nor did the trustees contribute any vital additional services to the business, managerial or otherwise. As employees they had performed managerial and other vital services, and after purporting to become trustee-partners they continued as employees to perform the same services. They participated in the management of the business only as employees, not as partners; and they were paid salaries for their services as employees, not as partners. Taxpayer reserved to himself control over the

business, and in practice he exercised such control. (R. 29.)

A fiscal year ending January 31 was adopted for the business, and a partnership return was filed for the nine-month period May 1, 1941, to January 31, 1942. Of the net profits 51% was allocated to taxpayer, and 49% to the trust. The trust adopted a fiscal year ending October 31, and reported 49% of the profits for its fiscal year ending October 31, 1942; the tax on the income reported by the trust was paid by the business. The Commissioner disregarded the alleged partnership between taxpayer and the trust and determined that the entire net income of the business for the eight-month period May 1 to December 31, 1941 (i.e., eight-ninths of the income reported by the "partnership" for the nine-month period ending January 31, 1942) was includible in taxpayer's 1941 gross income. (R. 27-28.) The Tax Court, relying on *Commissioner* v. *Tower,* 327 U. S. 280, and *Lusthaus* v. *Commissioner,* 327 U. S. 293, sustained the Commissioner's determination. (R. 28-31.) The Court of Appeals affirmed. (R. 151-159.)

ARGUMENT

There is no occasion for further review. This case is controlled by *Commissioner* v. *Tower,* 327 U. S. 280, and *Lusthaus* v. *Commissioner,* 327 U. S. 293, with which the decision below is in complete accord.

1. The question here is the same as that resolved in the *Tower* and *Lusthaus* cases, *supra.* This Court there held that partnerships predicated upon intra-family transfers of business capital are without federal income tax significance, though valid under state law and as to third parties, if the arrangement produces no substantial change in the creation of the business income but merely a reallocation of it within the family. Unless the transferee-partner "invests capital originating with her or substantially contributes to the control and management of the business, or otherwise performs vital additional services, or does all of these things" (*Commissioner* v. *Tower, supra,* p. 290), the Tax Court is fully justified in concluding that the claimed partnership lacks economic reality. In the *Tower* case a gift by a husband to his wife of a portion of his business capital was held ineffectual to render the wife his partner for tax purposes. In the *Lusthaus* case this Court held that no different result obtains where the husband purports to sell some of the capital to his wife for a consideration payable partly with donated funds and partly out of the share of the business income ascribed to her as a partner. The principles underlying these decisions apply with full force where, as here, the transfer is made in trust for the benefit of members of the taxpayer's family and the ensuing partnership agreement is with the trustee; passage of titular ownership of some of

the husband's business capital to a trustee instead or directly to the donee affects the legal form, not the economic substance, of the arrangement. *Hash* v. *Commissioner,* 152 F. 2d 722 (C.A. 4), certiorari denied, 328 U. S. 838, rehearing denied, 328 U. S. 879; *Eisenberg* v. *Commissioner,* 161 F. 2d 506 (C.A. 3), certiorari denied, 332 U. S. 767; *Belcher* v. *Commissioner,* 162 F. 2d 974 (C.A. 5), certiorari denied, 332 U. S. 824; *Economos* v. *Commissioner,* 167 F. 2d 165 (C.A. 4), certiorari denied, 335 U. S. 826; *Dawson* v. *Commissioner,* 163 F. 2d 664 (C.A. 6); *Benson* v. *Commissioner,* 161 F. 2d 821 (C.A. 5); *Losh* v. *Commissioner,* 145 F. 2d 456 (C.A. 10); *Quon* v. *Commissioner,* 165 F. 2d 215 (C.A. 9).

As is plain from its opinion, the Tax Court applied the test prescribed in the *Tower* and *Lusthaus* cases. It addressed itself to the crucial question of whether the trust which taxpayer created for the benefit of his wife and children, and which he purported to make his partner, contributed any new capital or services (managerial or otherwise) to the business. It concluded (R. 28-30) that neither of these alternative requirements had been met and, as the court below pointed out (R. 155-159), the evidentiary support for that conclusion is unassailable. As for the capital allegedly contributed by the trust, it consisted of nothing more than a portion of the capital already invested by taxpayer in

the business; taxpayer merely purported to "sell" 49% of his interest to the trust in exchange for a note payable out of a corresponding percentage of the business profits ascribed to the trust as his "partner". (R. 25-26, 27, 29.) Cf. *Lusthaus* v. *Commissioner, supra.* As for the vital additional services allegedly contributed by the two employee-trustees, they consisted of nothing more than a continuation of the same services already being performed by them *qua* employees; indeed, the only payments made to them by the business were made to them as employees, not as partners. (R. 24, 29.) What is more, under the partnership agreement taxpayer expressly reserved the right to determine all important policy matters affecting the business, as well as the right to terminate the services of the employee-trustees. (R. 26, 29.) And he in fact exercised such control. (R. 24, 29.) In short, after formation of the "partnership" the business was carried on in substantially the same manner as before. The employee-trustees became "partners" in name and on paper only. "By the simple expedient of drawing up papers, single tax earnings cannot be divided into two tax units and surtaxes cannot be thus avoided". *Commissioner* v. *Tower, supra,* p. 291. Here, as in the *Lusthaus* case (p. 297), "the partnership arrangements were merely superficial, and did not result in changing the husband's economic interest in the business". Since the Tax Court applied the correct principles, and

its decision has solid evidentiary support, affirmance by the court below was clearly correct.

2. In *Commissioner* v. *Culbertson*, No. 313, certiorari granted December 6, 1948, upon which taxpayer chiefly relies (Pet. 10), the Tax Court followed this Court's holding in the *Tower* and *Lusthaus* cases, but the Court of Appeals reversed. The case called for further review because, as pointed out in the Government's petition for certiorari, if the decision of the Court of Appeals were allowed to stand it would seriously undermine the *Tower* and *Lusthaus* decisions. See also petition for certiorari in *Commissioner* v. *Hartz*, No. 520, filed January 25, 1949. Here both courts below have adhered to the *Tower* and *Lusthaus* decisions, and there is no more occasion for further review of this case than of similar family trust-partnership cases (*Hash* v. *Commissioner, supra; Eisenberg* v. *Commissioner, supra; Economos* v. *Commissioner, supra; Belcher* v. *Commissioner, supra*) in which certiorari has been denied.

3. Taxpayer's contention (Pet. 14-15) that the decision below unconstitutionally taxes him on the income of another begs the issue. The income in question is taxable to taxpayer, rather than to the trust-partner, because it was earned by taxpayer. To permit the tax consequences to turn upon the considerations stressed by taxpayer would sanction the very type of formalism which this Court

in the *Tower* and *Lusthaus* cases refused to recognize as effectual to alter tax liability.

CONCLUSION

The decision below is in accord with the decisions of this Court in the *Tower* and *Lusthaus* cases, and there is no occasion for further review. The petition for a writ of certiorari should be denied.

Respectfully submitted,

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Internal Revenue Code:

SEC. 11. NORMAL TAX ON INDIVIDUALS.

There shall be levied, collected, and paid for each taxable year upon the net income of every individual a * * * tax * * *.

(26 U. S. C. 1946 ed., Sec. 11.)

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service * * *, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

(26 U. S. C. 22.)

SEC. 181. PARTNERSHIP NOT TAXABLE.

Individuals carrying on business in partnership shall be liable for income tax only in their individual capacity.

(26 U. S. C. 181.)

SEC. 182. TAX OF PARTNERS.

In computing the net income of each partner, he shall include, whether or not distribution is made to him—

* * *

(c) His distributive share of the ordinary net income or the ordinary net loss of the partnership, computed as provided in section 183 (b).

(26 U. S. C. 182.)

SEC. 3797. DEFINITIONS.

(a) When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof—

* * *

(2) *Partnership and Partner.*—The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term "partner" includes a member in such a syndicate, group, pool, joint venture, or organization.

* * *

(26 U. S. C. 3797.)

Treasury Regulations 103, promulgated under the Internal Revenue Code:

SEC. 19.22 (a)-1. *What included in gross income.*—Gross income includes in general compensation for personal and professional services, business income, profits from sales of and dealings in property, interest, rent, dividends, and gains, profits, and income derived from any

source whatever, unless exempt from tax by law. (See sections 22 (b) and 116.) In general, income is the gain derived from capital, from labor, or from both combined, * * *.

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